
L. R. B. & M. JOURNAL

VOLUME 25

NUMBER 1

JANUARY 1944



YOU **BUY**'EM



THEY **FIRE**'EM



4th WAR **DRIVE**
LOAN **NOW ON!**

Published by
LYBRAND, ROSS BROS. & MONTGOMERY
Accountants and Auditors

Table of Contents

War Contract Termination Settlements . . .	1
--	---

By DONALD M. RUSSELL

The Tentative Nature of Financial State- ments Under Present Conditions . . .	10
--	----

By ALVIN R. JENNINGS

Editorials:

War Impedes Progress of Science . . .	25
---------------------------------------	----

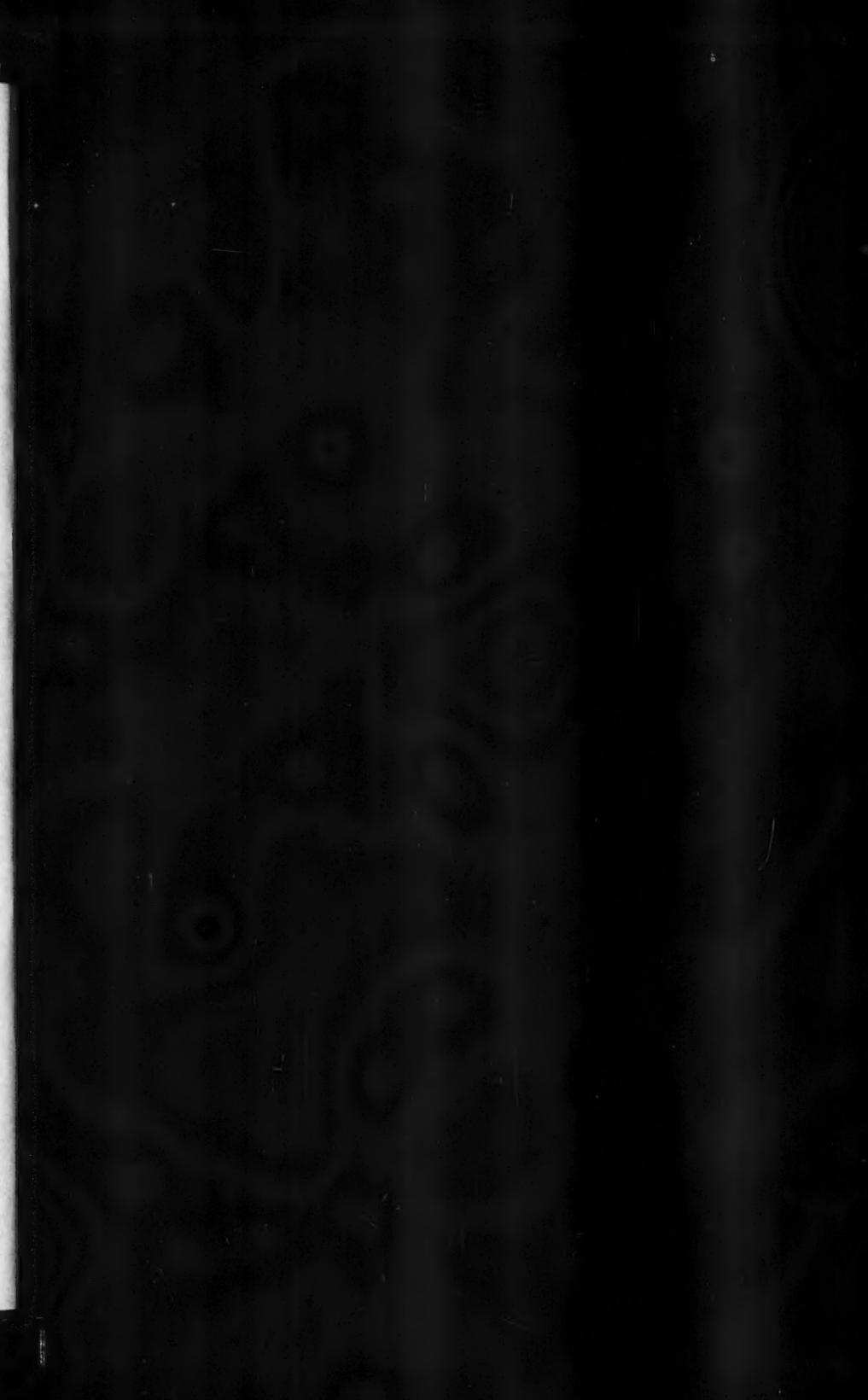
Defects in Federal Tax Law and Ad- ministration	26
--	----

Montgomery's Tax Books	27
----------------------------------	----

Notes	28
-----------------	----

KEEP UP THE DRIVE:

DON'T STOP BUYING



L. R. B. & M. JOURNAL

VOLUME 25

JANUARY 1944

NUMBER 1

War Contract Termination Settlements*

BY DONALD M. RUSSELL

Before peace-time production can be resumed in converted industries, war-time machines and materials must be moved out of the way. Before this can be done the machines and materials must be inventoried, the costs must be determined, and settlements must be made with the Government. Participation in the development of settlement procedures, education of management as to the ground rules controlling settlements, and effective participation in the preparation of settlement proposals present a distinct challenge to public and private accountants.

THE COMPTROLLER-GENERAL CONTROVERSY

The Council of the American Institute has taken a firm position in the controversy concerning negotiated settlements, and has presented its views to Congress and the public. On October 21, 1943, it adopted a resolution which concludes as follows:

*Based on an address delivered at the Regional Cost Conference held in Philadelphia on November 29, 1943.

And therefore it is the firm conviction of this Council:

That negotiated settlements should be permitted with proper safeguards,

That settlements should be made promptly and once made should be final and binding in the absence of fraud, and

That proper records relating to all such settlements should be kept and be available for such examination as the Comptroller-General may wish to make to determine whether or not fraud exists.

The War Department has done an outstanding piece of work in its Procurement Regulation No. 15 and the related Termination Accounting Manual in planning a termination procedure which makes use of modern methods of accounting and auditing. The so-called "legal audits" conducted by the General Accounting Office, based upon the legal opinions of the Comptroller-General, impose upon business many disallowances of costs under strained concepts that the expenditures (usually expenses included in general overhead) are not "necessary for the performance of the contract." New legislation is required which will make this type of audit unnecessary in the termina-

tion of fixed price contracts and which would insure a broader recognition of all costs by the Comptroller-General's Office. Unless this is done serious bottle-necks will develop not only in the settlement of fixed price contracts but also in the settlement of cost-plus-fixed-fee contracts.

The Comptroller-General had indicated in his testimony that negotiated settlements would be made between two individuals acting alone. The Under Secretary of War, Robert P. Patterson, stated this idea to be completely wrong. The "contracting officer," is in practice, not a single person but an organization, including specialists in purchasing, engineering, law and accounting. The negotiated settlements proposed in P R 15 are not to be mere horse trading; they are to be based upon and supported by a record of the facts after reasonable audit.

C. P. F. F. CONTRACTS, ARMY AND NAVY

All cost-plus-fixed-fee contracts will be settled under the same cost definitions and the same procedures by which the costs prior to termination are recovered; that is, the costs are usually as defined by Treasury Decision 5000 and are subject to cost inspection, and later to audit, by the General Accounting Office.

FIXED PRICE CONTRACTS, NAVY

The Navy has not published as

complete regulations for the termination of fixed price contracts as are included in P R 15 and the Termination Accounting Manual of the Army, and it has adopted termination clauses which differ from the Army clauses.* The Navy uses one standard clause for fixed price contracts of less than \$500,000 and another for contracts in excess of that amount.

FIXED PRICE CONTRACTS, ARMY

The War Department's procedures for termination of fixed price supply contracts are set forth in P R 15 and the Termination Accounting Manual. Under this plan the field of authorized negotiation comprises the entire amount of the settlement. The policies and principles are, however, described in considerable detail. The contractor is to prepare a "proposal" (the word "claim" is in disrepute) in which he sets forth full details of his inventory or costs and of the computation of an "indicated rate of profit on the contract." The extent of the reviews to be made for both prime contracts and subcontracts is indicated but is always subject to the judgment of the contracting officer.

If this type of negotiated settlement breaks down, settlement is to be made on a formula basis. Settlement (other than for the post-

*See, however, footnote on page 3 regarding the recently promulgated Baruch-Hancock Uniform Termination Clause and Cost Formula.

termination costs) is to be based upon audited costs, plus an amount for profit on the uncompleted portion equal to that part of "the profit which would have been realized on the uncompleted portion of the contract, if the contract had been completed and labor and material costs prevailing at the date of termination had remained in effect," which is proportionate to the percentage of completion of the uncompleted portion of the profit. If this formula basis is used, the cost interpretations of P R 15 do not apply and the rules as to cost are to be taken from the same reference as in Navy settlements, i.e., the "Explanation of Principles for Determination of Costs under Government Contracts" issued jointly by the War and Navy Departments in April 1942.

Under either the Army or the Navy procedures, the formula settlements provided, if negotiation breaks down, require the determination of actual cost. It follows that any settlements made by formula will be subjected to the "legal audit" of the Comptroller-General and cannot be considered conclusive and binding until after his review has been completed.

It is the announced policy of the War Department to offer to any contractor who does not have the standard termination clause provided by P R 15 in his present contract, an amendment which will include the standard clause and

permit the negotiated settlement procedure.

The subsequent comments relate solely to the negotiated settlement described in War Department P R 15 and the Termination Accounting Manual.*

SUBCONTRACTORS' SETTLEMENTS

Review of subcontractors' settlement proposals is a responsibility of the prime contractor in the first instance. The standard for his review is the degree of scrutiny "that a business man should employ in the conduct of his own affairs." The prime contractor is not required to warrant the accuracy of the facts presented by subcontractors. The certificate which the prime contractor attaches to a subcontractors' proposal includes the words, "the settlement in the amount of \$. is fair and reasonable, is proposed in good faith and is not more favorable to the supplier than one which the undersigned would make if reimbursement by the Government were not involved."

The rights of a subcontractor or supplier under a cancelled contract appear much stronger under common law than the right of a prime

*Since the writing of this article, the Director of War Mobilization has issued a directive to all procurement agencies (January 8, 1944) making immediately effective the Baruch-Hancock Uniform Termination Clause and Cost Formula. This appears to retain the general basis of P R 15 and the Termination Accounting Manual.

contractor similarly situated. The Government cancels by right of eminent domain. A subcontractor is entitled under common law to receive the entire amount of his contract less the amount he saved by not being required to complete performance; this means the entire prospective profit. Many subcontractors and suppliers have given up these rights by accepting purchase orders with special provisions in fine print. These relationships are discussed in an article, "Some Legal Aspects of War Contract Termination," by Ross Nichols in the November 15, 1943 Bulletin of the National Association of Cost Accountants.

Each subcontractor's claim should be submitted to the contracting officer promptly after it has been received and it may be submitted piecemeal. The War Department plans to handle the proposals of both prime contractors and subcontractors piecemeal in order to expedite the settlements. It will be desirable to furnish contracting officers with preliminary inventories, before pricing, so that the arrangements for the disposal of materials may get under way.

Ordinarily, small suppliers should be encouraged to use the inventory basis rather than the total cost basis in preparing their statements. An inventory proposal can be reviewed faster and with less expense to the prime contractor than a total cost basis proposal. Contracting officers

have been unwilling to state a definite dollar limit to the amount of the subcontractors' claims that may be passed by office review only. This is probably a sound position. It may be desirable to visit a supplier, who is known to be unfamiliar with dealing with the Government, when his first statement is presented, even though the amount involved may be small. After the reliability of the supplier has been established, larger amounts may be accepted on office review alone.

REPORTS OF CERTIFIED PUBLIC ACCOUNTANTS

There will be many opportunities for the public accountant to be of service. He may verify the quantities, descriptions and pricing of the inventories in a proposal prepared on the inventory basis; he may review or audit the costs of a proposal prepared on the total cost basis; he may verify costs incurred after termination; or he may advise his client as to the regulations and the form of the presentation to be made. Whatever the nature of his engagement, the wording of his report or "Statement of Opinion" should be such that he does not express an opinion that the proposed rate of profit is "fair" or reasonable; that matter is reserved for negotiation between the contracting officer and the contractor.

He will be careful to observe an objective approach to the facts; he should not appear as an advocate

for his client. To be of real assistance in settling a contract he must give the contracting officer the kind of information that officer needs, that is, factual and descriptive comments about the items in the proposal, the basis on which the items have been determined or computed, the scope of his review or audit, with emphasis upon adequate disclosure of borderline items. His report should be more a cost inspection report, based upon the Termination Accounting Manual, than an audit report.

PREPARATION OF SETTLEMENT PROPOSALS

The settlement proposal prepared by the contractor and submitted to the contracting officer should set forth the costs in detail, and should be accompanied by explanatory comments supporting the contractor's position. Items that are not clearly admissible under the Manual, and even items stated therein to be inadmissible if the contractor believes that unusual circumstances are present, such e.g. as reconversion costs under certain circumstances, may properly be included in the settlement proposal *if they are adequately disclosed as separate items* and the reasons for the treatment are clearly stated. The contractor will not receive consideration of any item unless he asks for it.

Settlement proposals may be prepared on either of two methods: (1) the inventory method, or (2) the

total cost method. What influences the selection of the method and what are the relative advantages and disadvantages?

The inventory method proposal consists of an inventory listing, priced at cost, item by item, as to raw materials, work in process, purchased parts, and tools. The profit allowance, if any, is added to the total inventory, and the termination expenses, subcontractor settlements and disposal credits are applied to that total to arrive at the amount of the settlement. This method requires completely developed data as to unit costs of all items in the inventory. It also involves determination of the percentage of completion of uncompleted parts included in work in process. Some concerns make a blanket assumption that parts in work in process must on the average be 50 pct. complete, and value the inventory accordingly. If any substantial amount is involved, this method will usually be unsatisfactory to the Government as a basis for payment. If the inventory method is to be used for work in process parts, time studies or other operation cost data should be available, and the records should show how many operations have been completed and the various uncompleted parts be priced accordingly.

The inventory method will therefore be suitable where adequate detailed costs are available, which is likely to mean in instances where

the product is similar to commercial product, in instances where the contract for a special war product is nearly completed at the termination date, or where the settlement relates principally to purchased parts. This method has the advantage of permitting the contractor to retain his entire profit on the completed portion of the contract, without renegotiation of the price with the contracting officer but is dependent upon having reliable cost information so that there is no question as to the costs of the completed and uncompleted portions of the contract.

In the total cost method of preparing a settlement proposal, the entire costs incurred on the contract from the beginning are listed and to this is added the negotiated amount of total profit. This profit may be computed separately on different elements of cost incurred, e.g., it is the policy of the War Department not to allow the full indicated rate of profit that would have been earned if the contract had been completed, to be applied to a stock of raw materials on which no labor has been expended. The final amount of the settlement is determined by deducting the payments that have been received for completed units, from the sum of the total costs incurred and the profit allowed, and adjusting the resultant amount for termination expenses, subcontractor settlements and disposal credits. This final amount

must not be greater than the original total amount of the contract.

The total cost method will be selected where unit costs by parts and operations are not available, and it will frequently be used when a contract is cancelled during its early stages. It has the advantage of not requiring a segregation of costs between the completed and uncompleted portions of a contract but it has the disadvantage of opening up the entire contract for renegotiation with the contracting officer, and may bring about the loss of a portion of the earned profit on completed units.

It should not be assumed that the total cost method does not require the preparation of an inventory, as the backbone of every termination settlement will be the inventory. It may be expected that when the total cost method is used the reviewers will expect to find an approximate agreement between the amounts of the uncollected costs on the contract and an overall reasonable value of the inventory.

Inventories should be taken immediately after termination; do not wait until disposals have been made; to do so is to complicate and confuse orderly settlement. Many settlements may be simplified, however, by omitting entirely those materials which the contractor is willing to assume. Any materials paid for in the termination settlement become Government property. The contractor must care for

them, safeguard them, and be ready to deliver them upon notice.

DEFINITION OF COSTS

The definition of costs in the Termination Accounting Manual is in accordance with sound cost accounting, but there are several limitations, and several special conditions are discussed.

The general requirement is that allowable costs must be:

- (1) Necessary for the performance of the contract;
- (2) Reasonable in amount;
- (3) Properly allocable to the contract, and
- (4) In accordance with recognized accounting practices.

It is the intention of the War Department to issue accounting bulletins from time to time discussing its interpretation of "recognized accounting practices."

War-time amortization of emergency facilities as permitted for federal income tax purposes when Necessity Certificates have been granted, is not at present an allowable element of cost. However, "loss of useful value" or war-time obsolescence of facilities is allowable to the extent proven and if the contractor agrees to protect the interests of the Government by transfer of title to the facilities or otherwise. Any claim for "loss of useful value" must be presented as a separate item in the proposal, apart from ordinary depreciation and obsolescence. Any such claim is limited to

the amount which, when added to special allowances for engineering, development and special tooling, is not "greater than the contract price payable, if the contract had been completed, less the amount of all costs which the contracting officer estimates would have been required to perform the contract completely." The deduction for costs in the foregoing definition means all other costs.

A proper proportion of institutional advertising is allowable; this is not permitted in C. P. F. F. contracts under T. D. 5000.

Federal capital stock tax is allowable; this also is excluded under T.D. 5000 for C. P. F. F. contracts.

If there is no indicated rate of profit on the contract, interest is allowable to the extent that borrowed capital was used and was necessary for the contract.

EXCLUSIONS FROM COST

The Manual provides certain exclusions from cost which should have careful consideration; it is believed, however, that these will not work undue hardship if the contractors take warning and act accordingly, e.g.:

Costs due to failure to stop work promptly upon notice. This means negligence or willful failure and it means reasonable promptness. In a doubtful case it would be wise to consult the contracting officer and to obtain his written

consent to any continuance of work.

Costs of materials and services in excess of the "reasonable requirements of the contract." A fair allowance for spoilage is permitted. It would seem that any quantities up to those required for complete performance of the contract plus the allowance for spoilage based on recent experience would be reasonable.

Costs of undeliverable materials, except to the extent the Government has expressly assumed responsibility.

SPOILED WORK

As to spoiled work that may be included in costs, remember that the Government accepts "actual" cost rather than a standard, normal or ideal cost. Because of this it has, even on C. P. F. F. contracts, paid the cost of excessive spoilage due to untrained labor, lack of familiarity with the operations or machines required for manufacturing a new product, and other causes. A frequent standard of spoiled work on peace-time production was 5 pct.; under war conditions this loss has amounted to 20 pct., 30 pct., or even higher in some circumstances. When the Manual refers to "normal spoilage in manufacturing" it must mean normal in the light of the recent operating conditions, that is, normal war-time rather than normal peace-time spoilage. In any instance where spoilage is being ex-

perienced in excess of 5 pct. it will be worthwhile to install now, if it has not been done before, records of spoilage by contracts or orders, so that when termination comes there will be evidence available to prove the claim. Excessive spoilage should not be buried in overhead expense accounts to be included in general distributions.

STARTING LOAD

Starting load costs are those non-recurring expenditures made early in the life of a contract, the benefits of which extend throughout the life of the contract. Such costs may be of many types, e.g.:

1. Engineering,
2. Production planning,
3. Subcontracting expense,
4. Factory rearrangement,
5. Cost of tools and fixtures,
6. Employee training, either separate from production or included in production,
7. Unusual quantities of spoiled work,
8. Machine break-downs.

If such non-recurring expenditures are expensed as costs in the months incurred and are not spread over the life of the contract, the computations of unit costs, and of the indicated rate of profit that would have resulted if the contract had been completed, will be distorted and cause loss to the contractor. There is some conflict here between general corporate account-

ing and Government cost accounting. Statistical cost records must be kept, whether the items have been expensed or deferred in the general books of account, which will provide the information required for the settlement proposal.

If any contract is terminated during the early months it may appear to be a loss contract, whereas, if it had been continued to completion it might well have shown a profit; therefore, any early termination which appears to be a loss contract should be studied carefully to determine the reason,—very likely starting load. The starting load problem is important wherever a manufacturer has undertaken to produce a product different from his regular line, and less so where he has sold a standard commercial product to the Government. The Manual expressly recognizes starting load costs and permits them to be spread in the computations. The burden, however, is on the contractor to show what profit would have been made. How can this be done?

If the nonrecurring expenses are recognized for what they are at the time, job cost sheets and time studies can be made which will provide the necessary statistics. In many instances this has not been done and in most smaller concerns it would be impracticable.

The following method has been used and found acceptable by the War Department in one instance. It was agreed that all of the "bugs"

had been eliminated from production by the end of the first month. The total costs for that month were divided by the units produced and a unit cost determined which was found to be very high. The unit costs were determined for the second month and for the seventh month, which was the last complete month before termination. It was found that the unit costs were much lower and that the last month was the lowest, reflecting the fact that operating efficiency had improved steadily. The difference between the unit costs for the first and last months was multiplied by the number of units produced in the first month to obtain the dollar amount of the starting load. This was then amortized over the number of units called for by the contract and the unamortized balance of the starting load as at the date of termination was allowed as an item of recoverable cost in the termination settlement; moreover, the indicated rate of profit that would have been earned if the contract had been completed was adjusted accordingly.

COMMON ITEMS

The problem as to common items refers to the allocation to one contract which has been cancelled, of some portion of the stock of raw materials or manufactured or purchased parts which are identical and which may be used on other con-

(Continued on page 31)

The Tentative Nature of Financial Statements Under Present Conditions*

BY ALVIN R. JENNINGS

The following is quoted from the report of the President of The Woodward Governor Company to stockholders for the year 1942:

In considering the financial statements which are a part of this report, you must therefore realize that they may not give an accurate picture of the present financial condition of the company or a sound basis upon which to predict the company's future financial progress.

The "therefore" referred to the contingencies inherent in the possibility of renegotiation of the company's war contracts. It might well have been to any one of a number of imponderables which at present confront management in preparing financial reports.

Much has been written recently about the tentative character of present day statements but I have

chosen to discuss that subject because I believe a great deal of emphasizing can be done before we reach the point of over emphasis. I am aware that there is one school of thought which appears to believe that the topic should be soft-pedaled—that the layman's confidence in financial statements may be shaken to the point where question of the wisdom of issuing any further statements until the cessation of hostilities might be raised. I doubt very much that any such question would arise in the minds of any considerable group of responsible people whether they be stockholders, bankers or other credit grantors. Even though I regard the possibility as remote, I would rather see the question eventuate than to have it avoided merely by reason of the failure to appreciate the true significance of conditions under which most statements are necessarily being issued today. The question, as I see it, is not one of the use, or utility, of present day statements but rather one of avoiding, if we can, the misuse of such statements by those who are not so well informed as the management or the independent public accountant who examines the statements.

*This article is a digest of a lecture given by Mr. Jennings before the Practising Law Institute in May 1943. In order to bring the consideration of renegotiation up to date, the summary of the Institute's Accounting Research Bulletin No. 21, promulgated in December, 1943, has been incorporated in this digest.

Peacetime Uncertainties

Financial statements are digests of the figures and facts accumulated in the accounting records, summarized in the manner which management believes most fairly and clearly presents the story. Accounting is not one of the exact sciences, nor based on immutable laws. On the other hand, it is not capricious; it follows certain basic tenets, concepts, practices or doctrines which for want of a better word are referred to as principles. Management within limits has the prerogative of selecting and applying those principles which it regards as best suited to the circumstances.

It has become traditional for companies to report the results of their operations at least annually. In some instances, summarized information may be published as often as quarterly during any given year. The annual period of financial reporting corresponds with the fiscal year which the company has adopted. Unfortunately, it is the exceptional case in which the fiscal year coincides with the natural cycle of business transactions; more often than not the end of the adopted fiscal year occurs in the middle of such a cycle. In certain industries where the process of fabrication is one of long duration, as for example in the tobacco industry where the leaf is permitted to age for two to three years before it is used, it is obviously impossible

for any fiscal year to span a complete phase of operations. Conversely, the retail merchant may have several complete cycles within one fiscal period.

You know from your experience in preparing tax returns that there are two general bases on which accounts are kept. One is the cash basis; the other is the accrual basis. The cash basis is suited to only a limited number of undertakings and can be disregarded for present purposes.

One of the accounting conventions to which I have previously referred, and which applies to the accrual method, is predicated on the theory that, insofar as may be possible, it is desirable to reflect in any given accounting period all costs, expenses and losses which may be related to the income for that period. This is sometimes referred to as the "matching of costs and income." The United States Supreme Court in *U. S. v. Anderson*, 269 U. S. 422, a case decided approximately 25 years ago, indicated that a basic principle of the accrual method of accounting is that of "charging against income earned during the taxable period the expenses incurred in and properly attributable to the process of earning income during that period."

Accordingly, in closing the accounts for the fiscal period it is necessary to take stock not only of the merchandise purchased or manufactured and unsold at the end of

the period but also of any other incompleting transactions which have a relationship to the income for the period. Judgment and experience play a large part in these determinations. Among other questions which will arise is the valuation which is to be placed on inventories on hand; the determination of the amount which should be charged to the period as representative of the portion of the cost of fixed assets utilized in production for the year; the recognition in the accounts of possible losses that may be sustained in collecting accounts receivable which arose from sales made in the period, etc.

Under normal conditions income from sales or other sources can generally be measured with a satisfactory degree of finality and uncertainties inherent in the determination of the results of operations in most cases are concerned with cost and expenses.

Even before the war the complexities of the Internal Revenue Code were such that provision for taxes calculated at the time of closing the accounts in many instances could, at best, be only approximations of the amounts which might ultimately be payable upon taxable net income as determined by the Bureau of Internal Revenue.

One of the costs which in normal times is often subject to subsequent revision is the provision for depreciation of fixed assets employed in the business. The accounting prin-

ciple of depreciation is to allocate expenditures for fixed assets to those periods during which it is expected that the assets will be utilized in operations. Adherence to this principle necessarily involves an estimate as to the probable life of the equipment. This in turn is dependent upon a number of circumstances which cannot always be foreseen at the time when the determination must be made. To illustrate, the theoretical life of a piece of equipment is influenced to a substantial degree by the policy which pertains in respect of repairing and maintaining the equipment. Relaxations to any material degree in the maintenance policy will of necessity tend to alter the probable life of the equipment as originally determined. Also, while the loss of useful life of equipment may be indicated within reasonable limits by experience, it is seldom if ever possible to foresee the effects upon such life of obsolescence which may arise from technological causes.

Again, in those industries where natural resources are involved, accounting recognition of depletion is necessarily based upon engineering estimates of the total resources which can be worked economically. It is not at all infrequent for new veins to be discovered after the operations have been under way for some time. On the other hand, economic conditions may change so as to make it unprofitable to continue operations. Consequently,

readjustments of fixed asset accounts are not exceptional in corporate accounting. Some such adjustments reflect revisions of depreciation rates dictated by tax considerations.

The foregoing are but a few illustrations of the reasons why, even in peacetime, financial statements express opinions based upon judgment rather than facts determined with microscopic accuracy.

Wartime Uncertainties

The uncertainties which normally exist in the determination of results for the accounting period are intensified and multiplied in time of war. The problems are not new in the sense that their characteristics are such as to raise questions concerning the applicability of existing recognized principles. They are notable primarily because of the degree or scope of their possible effects. Often they are occasioned by the absence of the factual data or evidence which is a prerequisite to the intelligent appraisal of their significance.

For purposes of discussion, the accounting problems arising from the transition from a peacetime to a wartime economy may be broadly classified into: (A) those which have a definite relation to the determination of results for the period, and (B) those which are related to contingencies of the future. Stated in another way, those in group (A) would, under generally accepted ac-

counting principles, be mandatory considerations in the determination of results for the period, while those in group (B) might, but need not necessarily, be recognized by management through the creation of special reserves. In subsequent reference, the two categories are designated, respectively, as "mandatory" and "optional." At this point it would be well to observe that the line of demarcation is often obscure. Accordingly, the classifications which later follow are presented for convenience of discussion and are not intended to be absolute. Whether a set of circumstances would be treated in practice as mandatory or optional would depend upon the facts of the particular case.

The mandatory classification may be subdivided into those situations which affect the determination of (a) gross income and (b) related cost and expenses.

MANDATORY CONSIDERATIONS— GROSS INCOME

In normal times not much difficulty is experienced in ascertaining sales or revenues for the period within reasonable limits. Most material for the present conflict is being procured by the government under one of two general types of contract—the cost-plus-fixed-fee and the fixed (or negotiated) price contract. Difficulties, not to mention annoyances, exist in measuring

income under both types of contract.

Income Under CPFF Contracts: While it is ordinarily considered permissible to accrue the fee under a CPFF contract as it becomes billable, the circumstances of each case should be considered to ascertain whether that procedure is preferable to the conventional practice of determining income based upon delivery or of percentage of completion. This question is too complex to be dealt with fully on this occasion. Those sufficiently interested are referred to Accounting Research Bulletin No. 19 issued by the Committee on Accounting Procedure of the American Institute of Accountants for a full discussion of the topic.

One contingency which must be recognized in accounting for results under CPFF contracts is the probability of the disallowance by the government of some of the incurred costs. No mutually exclusive definitions exist which enable the automatic classification of costs into those allowable and those which are inadmissible. Where the same contractor is producing both commercial goods and war material, or if he is producing exclusively under government contracts some of which are of the CPFF type and some of the Fixed Price variety, complications and possible grounds of disagreement with the audit branches of the government may be encountered in the allocation of indirect

costs among the various classes of business or contracts.

In some cases the amounts involved in differences of opinion between the contractor and the government are relatively material. If the experience of World War I is indicative, the issues may not be resolved with finality for some years after the cessation of hostilities. In other instances the amounts in question are not substantial enough to affect results for the period materially.

Contract Renegotiation: The principal contingency in Fixed Price contracts is that of renegotiation of the contract price under Sec. 403 of the Sixth Supplemental National Defense Appropriation Act, 1942 (Public, 528) as amended by Sec. 801 of the Revenue Act of 1942 (Public, 753). Fees under CPFF contracts are also subject to renegotiation. The uncertainties inherent in renegotiation proceedings were perhaps the most important of the unknowns which required consideration in closing the accounts for the year 1942.

The reports of many companies to their stockholders for the year 1942 include comments describing the status of renegotiation. In many such cases stockholders were specifically informed that the financial statements in the annual reports were necessarily tentative and subject to revision. A typical statement to this effect appeared in the

report of Pullman, Incorporated, in the following words:

Unless and until renegotiation has been completed, earnings figures shown in this report for the manufacturing division must be considered as tentative and subject to revision.

At the time when the accounts were being closed for the year 1942 contractors found themselves in one of the following positions in respect of renegotiation:

1. Renegotiation proceedings had not been begun and the company had not been requested to furnish any information to the Price Adjustment Board for the purpose of enabling the Board to determine whether proceedings should be instituted;

2. At the request of the Price Adjustment Board financial data for past years had been prepared or was in process of preparation for submission to the Board;

3. Financial data had been prepared and submitted and discussions had been held with the Price Adjustment Board but no final conclusions had been reached as to the amount, if any, which was to be repaid by the contractor to the government;

4. Renegotiation proceedings had been concluded and an agreement had been signed providing for repayment by the company of a specified sum.

In most of the renegotiation proceedings which were instituted by the government prior to the end of

the year 1942 the conclusions reached were based in part upon estimated data. Most, if not all, of the resulting agreements contain a proviso that, if the actual results for the period as ultimately determined differ materially from the estimated data, the government has the right to reopen the case for further consideration.

In those cases where renegotiation had been completed and an agreement reached before the accounts for the year were closed the general practice was to reflect the results of the agreement in reporting for the year 1942. In those cases in which partly estimated data were used, the only remaining contingency was the possibility of the case being reopened. In these circumstances the contractor usually had a fairly good idea of the percentage of profit which was regarded by the government as being reasonable and no particular problem was involved in calculating a provision for further repayment if the results for the year seemed to indicate that such further payment would be required.

In still other cases, the renegotiation proceedings may have been under way at the time when the accounts for the year were being closed. Discussions may have been held with the Price Adjustment Board and the company and the Board have been unable to agree on the amount which might constitute a reasonable profit in the circum-

stances. There may have been disagreement as to the appropriate treatment of certain expenditures made by the company, or the difference of opinion may have been on the relative weight to be assigned to any one of a number of the factors which are considered by the Board in its determinations. In these cases the company has a rather delicate problem with which to deal. On the one hand, it may be desirous of so preparing its statements as to make provision for all known contingencies on the most conservative basis possible. On the other hand, it is reluctant to give formal recognition in the accounts to the government's point of view. That situation is well illustrated by the case of the Consolidated Aircraft Corporation. The net income of that company for the fiscal year ended November 30, 1942 as reported in the report to stockholders for that year was approximately \$10,800,000. In determining net income the company had made provision for very substantial sums which it had voluntarily agreed to return to the government. It would appear from the president's report to stockholders that the corporation and the Price Adjustment Board had been unable to reach an agreement as to the amount of profit which the corporation would be entitled to retain for the year. The amount at issue was approximately \$6,000,000. In the circumstances the president pointed

out that it was important that stockholders should realize that the financial statements which were included in the reports did not reflect the financial position and earnings of the corporation as they might finally be determined or adjudicated.

Then there is the case of the contractor, whose results for the year indicate that beyond much question some refund will be claimed by the Government but who has not had any formal discussions with the Price Adjustment Board. The contractor understandably does not wish to prejudice his future discussions with the Board by making provision in his accounts for an amount which may possibly exceed that which he is eventually called upon to repay.

There are other instances in which only a small portion of a contractor's total business is subject to renegotiation. If officials of the contractor and the independent accountant are both of the opinion that the amount, if any, which may be repaid to the Government would not be relatively material in relation to the operating results for the year, the matter is generally dealt with by a disclosure of the facts in a note to statements.

The Securities and Exchange Commission in connection with a filing on Form S-2 issued a deficiency letter specifying the information which is required to be stated in financial statements in respect of

renegotiation when such statements are to be filed with the Commission. The data required are designed to indicate the status of renegotiation proceedings and to permit of an appraisal of the general significance of renegotiation in relation to the statements in question.

In December 1943 the Committee on Accounting Procedure of the Institute of American Accountants issued Accounting Research Bulletin No. 21, which expresses the present view of the profession regarding the treatment of the renegotiation contingency in financial statements in the light of developments to date. Following is the Summary Statement of the Bulletin:

(1) Since renegotiation proceedings have now been conducted over a considerable period of time, it is to be expected that many companies, particularly those which have completed renegotiation proceedings for a prior year, will be in a position to make reasonable provision for renegotiation refunds in their current financial statements, in accordance with the long recognized accounting principle that provision should be made in financial statements for all liabilities that can be reasonably estimated.

(2) Where such provision is made, there should be disclosure in the financial statements, by footnote or otherwise, of the basis upon which it is made. It is recognized

that by reason of changed conditions, a settlement made in the preceding year may not, in some cases, be indicative of the amount refundable in respect of the current year, and the provision made should take account of this possibility. If, however, the provision is materially less than the amount which would be indicated on the basis of a prior year's settlement, the reasons therefor and the approximate effect of the difference upon the net income were a refund required on the same basis for the current year, should be stated, except as hereinafter provided.

(3) Where a provision is not made, a statement to that effect should be set forth in a footnote, together with appropriate disclosure of the reasons therefor and of the company's renegotiation status. If a settlement has been effected for a prior year, such disclosure should, except as hereinafter provided, include a statement of the approximate effect upon the net income were a refund required on the same basis for the current year.

(4) The information required under paragraphs (2) and (3) above in respect of the effect of applying the basis of a prior year's settlement to the current year, may be omitted if there is substantial reason to believe that misleading inferences might be drawn therefrom. In such cases, however, a statement should be made why the

basis used for the prior year is not applicable to the current year.

(5) Provision for renegotiation refunds should be included in the balance-sheet as a current liability. In the income statement such provision should preferably be made as a deduction from sales, with the income and excess-profits tax and post-war refund computed accordingly. However, because of the interrelation between renegotiation refunds and income and excess profits taxes, the provision may be set forth in the financial statements in conjunction with the provision for taxes, either as separate items or as a combined amount.

(6) If the renegotiation refund required to be paid for any year is different from the provision made therefor in the financial statements originally issued for such year, the difference should be included in the current income statement unless such inclusion would result in distortion, in which event the adjustment may be made through earned surplus. Where earned surplus is thus charged or credited the reported results of the preceding year should be appropriately revised. The committee believes that this can best be done by presenting a revised income statement for the prior year, either in conjunction with the current year's financial statements or otherwise, and it urges that this procedure be followed.

MANDATORY CONSIDERATIONS— COSTS AND EXPENSES

The following discussion should be regarded as illustrative rather than as a complete enumeration of those considerations which have previously been referred to as "mandatory" in the determination of results for the period. In practice, not every case will be characterized by the existence of all the factors mentioned. In particular instances other uncertainties will arise which must be carefully considered and measured, insofar as it is possible, and recognized in the accounts.

Inability to Take Physical Inventories: In many cases because of the urgency of production requirements it was not feasible to take physical inventories of materials, work in process and finished products preparatory to closing the accounts for the year 1942. The possibilities of errors creeping into the book records of inventories, or of shortages existing for other reasons, are substantially greater under prevailing operating conditions and with the volume of business which is being handled today than would normally be the case.

In those instances where it was not possible to take a physical inventory before closing the accounts for the year 1942, it seems quite likely that the accuracy of the book accounts at that date will never be conclusively established. If and when it again becomes possi-

ble to take physical inventories, the differences which may then be disclosed will necessarily include any undisclosed differences which existed at the end of the year 1942. With certain limited possible exceptions it will probably not be possible in any very definite way to identify the portion of the difference which may have occurred in 1942.

Inventories play such a major part in most concerns in the determination of the results for the year that the uncertainties which exist by reason of inability to take physical inventories was of great concern to management. Many companies in closing the accounts for the year 1942, provided special reserves against inventories.

Accelerated Depreciation: Obviously, the expiration of life of a piece of equipment, where it is being used for more than a normal number of hours in a given day, is accelerated. Where there is a marked increase in the use of the equipment and consequent acceleration in the loss of utility, it is customary to recognize the situation in the accounts by increasing the normal annual provision for depreciation. Unfortunately, the Treasury has been chary of approving increases in rates of depreciation. Under existing high rates of excess profits taxes any provisions which may be made by the company and which do not constitute allowable tax deductions must of necessity be made

from the portion of the profits which otherwise would be available for stockholders. It can be appreciated that in the circumstances recognition, as such, in the accounts of accelerated depreciation arising from unusual wear and tear of equipment is not as frequent as might otherwise be the case.

Amortization of Emergency Facilities: Under the Internal Revenue Code if a taxpayer invests in facilities which are required for war production, he may apply for a Certificate of Necessity. If the Certificate is granted the taxpayer has the privilege, for tax purposes, of amortizing the cost of the facilities over 60 months. If at the end of present hostilities the President should declare the emergency period to be less than the 60-month period, the taxpayer is entitled to a recomputation of his taxable income for the intervening period and, to the extent that it was computed upon the basis of the 60-month period, taxable income will be adjusted to reflect the absorption of the cost of the facilities over the shorter period.

In the case of some companies which have applied for and received Certificates of Necessity, the management has believed that as a matter of prudence it is advisable in stating its accounts to absorb the cost more rapidly than is permitted for tax purposes. In any event since both the 60-month period or

the shorter period which may be adopted by management are arbitrary, and since the controlling factor in the final analysis will be the date of cessation of hostilities, which cannot now be foreseen, it is obvious that both the books of account and the tax returns of the company are provisional insofar as this item may be concerned. Incidentally, should the emergency period end before the expiration of the 60-month period, it is doubtful whether contractors will be able to persuade the Price Adjustment Board to reopen any years already renegotiated for the purpose of adjusting amortization.

Provision for Federal Taxes: Since taxes are interrelated with most of the other problems which were faced by management in stating accounts for the year 1942, they are necessarily one of the most important factors contributing to the tentative character of the financial statements. One or two illustrations of the difficulties which are experienced in attempting to provide adequately for taxes under present conditions should suffice.

Many companies which use the invested capital method to compute their excess profits tax credit have corporate histories which go back prior to the excess profits law of 1917. In many such cases there never has been a conclusive determination of the many invested capital questions which arose under

the old law. Many cases were compromised which left major questions unsettled. In any event I do not believe that it has yet been clearly established that the Treasury necessarily will feel that it is required to recognize the determinations under the Revenue Act of 1917 as a starting point for now computing invested capital under the Code. With an effective top excess profits tax rate of 81 per cent it is obvious that any sizeable adjustments of the invested capital by the Treasury will have a very significant effect upon net income after taxes. In a great many cases substantial grounds exist for differences of opinion with the Treasury and it is probably safe to say that the tax liability of many companies for the year 1942 may not be determined with finality for many years.

The common practice of companies which have problems of this sort is to attempt to provide for taxes on the most conservative basis in determining net income, i.e., on the premise that the Treasury will prevail on all debatable questions. At the same time, in preparing tax returns the company naturally takes advantage of the most favorable point of view. It is not strange, therefore, that the financial statements include reserves exceeding amounts which might be regarded as necessary minima.

The tentative character of financial statements is not overcome or eliminated merely by providing reserves on an ultraconservative basis. Provisions for reserves on the most conservative basis reasonably conceivable is to be encouraged; nevertheless the statements still retain their tentative character. While none of us can foresee what lies ahead with any degree of clarity, it is possible that no matter how conservative a given concern may be in making provisions for contingencies, subsequent events may show that the man who today is regarded as a pessimist in retrospect may appear to have been an optimist.

Those companies which do not compute their excess profits tax credit on the invested capital method but which use the average earnings method also have problems. The relief provisions of the Code, which were broadened by the Revenue Act of 1942, in some cases may ultimately prove to have a material bearing upon the final determination of the excess profits taxes, but the effect cannot yet be measured with any reasonable assurance.

If the experience following the last war is any criterion, here again it will probably be many years before final determinations can be made as to whether particular companies qualify for relief under the Code. It has not been my purpose to feature taxes particularly in this discussion. However, their influ-

ence today is so great that hardly a question of corporate policy or planning which arises for consideration can be intelligently considered without measuring its tax effects.

OPTIONAL CONSIDERATIONS

There is a surprising dearth of literature on the effect of World War I and its aftermath on corporate economy. Perhaps those concerned were too busy putting the pieces together to devote much of their time and energy to making an historical record of events and their consequences. Those members of management, financiers and those of my own profession whose experience spans the last quarter of a century, however, have vivid recollections which can be drawn upon even if there is a paucity of the written word. These memories are a valid basis for the present apprehension as to the post-war outlook. There seems to be little, if any, question that a very substantial portion of what, at the time, were regarded as satisfactory (even in some quarters as excessive) profits were not, in the final analysis, realized. In some instances, these profits were tied up in excessive plant facilities. In other cases they were represented by swollen inventories and the subsequent drop in price levels required extensive write-offs.

A study of some 65 manufacturing corporations which were involved in reorganization during the

1920's disclosed that the average write-off of assets in reorganization for the group amounted to 50 per cent of the assets which were reported in the respective balance sheets issued by the companies immediately preceding reorganization.* The author of the article concluded that the drastic write-downs would not have been necessary had adequate reserves been set aside out of income during the war and early post-war years.

In its report to stockholders for the year 1942, Pullman Incorporated pointed out that following World War I expenditures incurred for the rehabilitation and remodeling of Pullman cars jumped from approximately \$12,400,000 in 1918 to double that sum in 1921 and that, as a consequence, Pullman then recorded the first operating deficit in its history. The report proceeds to caution stockholders that similar expenditures of substantial amounts will be required after the present war.

If management needed any encouragement to recognize and make provision for those losses which, even though they may not presently be definitely measured, are nevertheless foreseeable contingencies, the stimulus has been provided from a number of sources. In the first place, the banks have retained their recollections of the cycle of

prices which prevailed after the conclusion of World War I. Secondly, Senator Walter F. George, in addressing the United States Chamber of Commerce on the occasion of its most recent annual dinner, stated that:

Reserves for post-war contingencies and for conversion to peacetime activities and for deferred maintenance and repairs must be established and built up out of earnings during the war.

and, again,

Provision should be made at once legalizing adequate reserves both to the individual and to the corporation.

Finally, the American Institute of Accountants through its Committee on Accounting Procedures undertook a careful study of what could be done to stimulate a conservative policy in the preparation of financial statements during the war period to provide against a post-war reaction. The results of the Committee's study were published in Accounting Research Bulletin No. 13, entitled "Accounting for Special Reserves Arising Out of the War." A number of purposes for which reserves could well be provided were named in the Bulletin.

It has been estimated that contract cancellations of all government agencies following World War I were equivalent to approximately 23 per cent of all war expenditures through April 1919.* Based upon

**The Need for Post-War Reserves*, National City Bank Letter, August, 1942.

**Cancellation of Contracts, World War I*, The Conference Board Economic Record, March 1943.

that record, it has been estimated that contract cancellations at the conclusion of the present conflict might aggregate from 25 to 75 billion dollars. Certainly contract cancellations can be listed as a major post-war consideration. It merits, and has been receiving, the attention of both representatives of the government and of contractors. It is believed that a relatively greater number of the contracts in World War II contain cancellation clauses than was the case in World War I. It has been reported that the standard contract cancellation clause in the last war was not adopted until six weeks prior to the ending of hostilities.

The scarcity of raw materials and the allocation programs adopted to insure an equitable distribution of essential materials among contractors have, to some extent, operated as a check against acquisition of stocks of raw materials and supplies which might well have exceeded the needs in particular cases. Before the adoption of the program of allocation, however, substantial increases occurred in inventories. When materials are hard to get there is a tendency for inventories and purchase commitments to get out of line with sales commitments and with reasonably foreseeable needs. This has been referred to by the indelicate as hoarding; to the defenders, it is the exercise of prudent foresight.

To protect their position insofar

as is possible in respect to contract cancellations many contractors have adopted the policy of allocating all purchases of raw materials and all work orders to specific sales contracts with the government. Such a procedure should be of substantial assistance in ascertaining the status of contracts as, if and when cancellation occurs. Wherever it is possible to do so, physical segregation or identification is highly desirable.

The desirability of distinguishing, in the reporting of operating results, between the "mandatory" and "optional" provisions which management makes is evident. Accordingly, the Committee on Accounting Procedure of the Institute in Bulletin No. 13 recommended that provisions of the first type should be reflected as charges in the income account before striking the balance of "net income" for the period. Provisions in the "optional" category, it was recommended, should be treated essentially as appropriations of net income for the period as otherwise determined. The Committee made it clear that it is not regarded as permissible under generally accepted accounting principles to create reserves merely for the purpose of stabilizing or equalizing reported income.

The Proof of the Pudding: The best evidence of the seriousness with which industry regards post-war prospects is presented by its action in providing for so-called

"war" reserves in the closing of accounts for the fiscal year just passed. As the basis for preparation of a tabulation* reflecting the extent of such provisions, the annual reports of approximately 30 corporations were selected for review. The list was prepared somewhat at random with a view to including a representative number of larger corporations which, it was known, are actively engaged in war work and some of the smaller or medium sized companies, only a part of the facilities of which were so engaged.

The results of the study may be summarized as follows: The aggregate net sales and other operating income was in round numbers, \$14,000,000,000; of that amount approximately \$2,125,000,000 remained after deducting manufacturing costs and operating expenses but before consideration of the federal taxes and any provisions made for war reserves. The effective average percentage of the provision for federal taxes of the group was 61.3 per cent of the \$2,125,000,000, so that tax provisions amounted to about \$1,305,000,000, and left income available for stockholders or for the provision of war reserves in the aggregate amount of some \$820,000,000. Of that amount management appropriated \$189,000,000, or about 23 per cent, for war reserves. This left approxi-

mately \$632,000,000 of income available for stockholders, which was equivalent to about 4½ per cent of the net sales or gross operating income of the group.*

It is understandable that management had some difficulty in putting into words the exact character of the contingencies against which the provisions were being made. While the general outline of the shape of things to come was recognized by many, each company apparently had its own conception and appraisal of the details. Accordingly, most of the companies in the group, in describing the purposes of the provisions, contented themselves with general phrases. One such typical phrase which with variations appeared frequently was "for contingencies arising out of war conditions." One description noted covered the field rather well. The provision was described as "against the risks attendant upon the liquidation of the present large inventories, post-war plant rearrangement and alteration, adjustment due to personnel reduction,

(Continued on page 31)

*A report upon a similar study made by The Conference Board was published in its April 1943 *Economic Record*. The results of that study, which embraced 495 concerns, indicated that the 30 companies selected for the present review comprise a satisfactory sample. The effective average percentage which federal taxes were of income in the case of the 495 companies was 61.0, and net income of the same group was 4.8 per cent of sales.

*The tabulation appears on page 32.

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. & Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

PARTNERS

WILLIAM M. LYBRAND	New York	WILLIAM F. MARSH	Pittsburgh
T. EDWARD ROSS	Philadelphia	DONALD M. RUSSELL	Detroit
ROBERT H. MONTGOMERY	New York	CARL T. KELLER	Boston
JOSEPH M. PUGH	Philadelphia	ALBERT G. MOSS	Dallas
WALTER A. STAUB	New York	J. F. STUART ARTHUR	Dallas
H. HILTON DUMBRILLE	New York	DON S. GRIFFITH	Seattle
JOHN HOOD, JR.	Philadelphia	FRED C. DENNIS	Cincinnati
HOMER N. SWEET	Boston	LOUIS D. KORK	Cleveland
THOMAS B. G. HENDERSON	New York	ALVIN R. JENNINGS	New York
GEORGE R. KEAST	San Francisco	CHRISTOPHER H. KNOLL	New York
PRIOR SINCLAIR	New York	JOEL D. HARVEY	Boston
NORMAN J. LENHART	New York	ALBERT E. HUNTER	Boston
DONALD P. PERRY	Boston	HARRY H. STEINMEYER	Philadelphia
WALTER L. SCHAFFER	New York	CARL H. ZIFF	Philadelphia
HOMER L. MILLER	Chicago	FRED M. BRESLIN	San Francisco
CONRAD B. TAYLOR	New York	HILTON R. CAMPBELL	New York
HERMON F. BELL	New York	EDWARD G. CARSON	New York
GEORGE R. DRABENSTADT	Philadelphia	HENRY C. HAWES	Chicago
A. KARL FISCHER	Philadelphia	GEORGE A. HEWITT	Philadelphia
WALTER B. GIBSON	Los Angeles	GEORGE W. MCIVER, JR.	New York
CLARENCE R. HAAS	Philadelphia	WALTER R. STAUB	New York

FRANCIS J. H. O'DEA

EUROPE
VICTOR L. NORRIS

LEONARD C. DAVID

War Impedes Progress of Science

The special issue of the L. R. B. & M. JOURNAL devoted to the commemoration in 1933 of the 35th anniversary of the founding of our firm contained, among other outstanding articles, one by Frank B. Jewett, Ph.D., Vice President of the American Telephone & Telegraph Company and President of the Bell Laboratories, Inc., on "Thirty-five Years of Applied Sci-

ence." In that article Dr. Jewett reviewed the developments in the field of applied science and the results of scientific research in the period which had elapsed since the founding of our firm.

The following account, which appeared in *The New York Times* of December 2, of an address delivered by Dr. Jewett the evening before, might well be described as a footnote to the above mentioned article which he had contributed to our 35th Anniversary Number:

Despite the many new inventions for which the war has been responsible, the progress of science has been impeded and little has been added to the world's store of fundamental knowledge, Dr. Frank B. Jewett, vice president of the American Telephone and Telegraph Company, told the New York University Institute on Post-War Reconstruction yesterday. Only a few of the technical discoveries since the war began will have peacetime applications, he declared.

"Progress in certain fields of scientific knowledge," Dr. Jewett explained, "has been offset by a virtual cessation of research work in others that are not considered essential to the war. In the main it has been an intense utilization of accumulated knowledge and skills for a particular limited objective, and much of the result has little prospective use outside the domain of warfare.

"There is no longer any intercourse between the scientific worlds of the warring nations and a minimum of free interchange within the nation itself. The conditions which are mandatory for general scientific progress disappear and everyone is bound by rigid rules of military secrecy."

Dr. Jewett cited a few instances in which the war had aided scientific progress. Radar in the field of aeronautics and Penicillin in the medical field were innovations adaptable to peacetime needs, he said.

Defects in Federal Tax Law and Administration

On June 25 last Colonel Montgomery sent a circular letter to the members of the American Institute of Accountants in which he not only expressed his views on the present tax law, but made constructive suggestions for changes in the Treasury's method of ex-

amining corporate tax returns. Some 600 replies were received to the letter, representing a wide distribution, including 216 different cities in 43 states, the District of Columbia, Cuba, Hawaii, Mexico and Puerto Rico.

The staff of the American Institute of Accountants made a careful analysis of these replies and prepared an informing report, of which a summary appeared in the January issue of *The Journal of Accountancy*.

The same issue of the *Journal* also contained an editorial, entitled "Tax Simplification," which included reference to the analysis of the 600 replies to Colonel Montgomery's letter.

The January issue of the magazine *Taxes*, in its department entitled Talking Shop, devotes considerable space to discussing the Colonel's letter and expressing approval of his suggestions.

On January 10 Representative Carlson of Kansas introduced a joint resolution in the House of Representatives calling for the establishment of a Federal Tax Commission, the efforts of which are to be directed toward the simplification of our Federal tax system, of the returns required thereunder, and of the methods of administration, and the effecting of various other improvements, including a better coordination of our Federal system with those of the States and local governments.

The Commission is to be composed of 15 members, including 4 members of the Senate Finance Committee, 4 members of the House Committee on Ways and Means, and one representative each of Agriculture, Labor, Business and Industry, Individual Taxpayers and Consumers, Tax Accountants, Tax Lawyers and Tax Economists.

Montgomery's Tax Books

The 1943-44 editions of *Montgomery's Federal Taxes on Corporations* and of *Montgomery's Federal Taxes on Estates, Trusts and Gifts* came from the press during December. The publishers make the following statement with respect to the work on corporation taxes:

The present law has now been in operation for a year. Its application to corporate problems, still in a formative stage a year ago, has been materially affected by new regulations, Treasury rulings, and Court decisions issued in its practical administration.

Some of these completely change interpretations earlier put upon the law. Some redound to the advantage of taxpayers, others to their disadvantage.

In this year's situation, too, there are cross-currents between provisions of the law, and between decisions relating to different provisions. These must be alertly watched. And in light of some decided cases and of litigation pending, it is imperative not to rely as much on precedent as has been possible up to now.

Among the items which are of particular present concern to corporations are these:

Whether a company is entitled to relief under Section 722, how much to claim, and when to file;

Recent Tax Court decisions under other sections—as that under Section 721 regarding *abnormalities of income*, which gives important indications as to how the Court is approaching this matter;

Status of *stock dividends*, an issue thought settled for several years, but reviewed during the past year and partly clarified by courts;

Cases before Supreme Court regarding effect of *excessive depreciation* in prior years—important because of recent tendency of the Court to review and on occasion reverse its previous stand on a number of points;

Handling of contributions to and the status of *pension and profit-sharing trusts*, on which considerably more light is now available;

Unusual care needed in all questions concerning *wage and salary stabilization*—particularly in view of changing regulations;

New election by oil and gas producers as to deduction of intangible costs.

The publishers emphasize that the work on taxes on estates, trusts and gifts summarizes into a composite picture the estate tax problem of today, including questions of viewpoint, alternative procedures and their consequences, in the light of developments resulting from the law in effect and its administration.

As in previous years, these books will be in constant use in our offices, and will be a valuable aid in enabling us to render the most effective tax service to our clients.

Notes

The article on "Post-War Accounting," which Colonel Montgomery wrote for the September issue of *The New York Certified Public Accountant*, has attracted considerable favorable attention. As with all of the Colonel's writings, his approach in the article was an eminently practical one.

The concluding paragraph of the article expresses a thought which may well be in the mind of every accountant as he looks forward to the post-war period:

It can do accountants no harm and it may be very helpful to give thought at this time to the place of accounts and accounting after the war. There will be changes. Too many things have happened and will happen to make men or things just the same in the period after the war as they were in the good old days. If fiscal systems are different, if wealth is redistributed, if we are to feed the world, isn't it reasonable to suppose that if we do not improve ourselves and the accounts we keep, some bureau of the government will improve the accounts and fire the old accountants? Isn't it obvious that if we are in—or approaching—a transitional period, accountants should be in it—a part of it—now—not after it's over?

An eminent member of the New York Bar, who saw a copy of the November issue of the L. R. B. & M. JOURNAL, wrote Colonel Montgomery as follows:

Thank you for your "Dream" reported in the November L. R. B. & M. JOURNAL. Having, on behalf of clients, searched for

some objective definition of a proper reconstructed excess profits credit under Section 722 and finding none in the Section, I resorted to my imagination to supply the deficiency.

To have an eminent authority such as yourself recommend the use of imagination in advising clients under this Section is very encouraging.

The "Twenty Years Ago" section of the monthly NACA Bulletin mentioned that in the January 2 Bulletin of twenty years ago, "a volume reviewed that month was AUDITING PRINCIPLES by Robert H. Montgomery and Walter A. Staub." The book was an adaptation to use in colleges and accounting schools of Colonel Montgomery's AUDITING THEORY AND PRACTICE which twenty years ago was already in its third edition, the first edition having appeared in 1912.

The following paragraphs appeared in a letter which one of our partners recently received from Mr. Davies in London:

Did you ever meet a senior by name of Humphrey Porter, who was with us in the Paris office and later in the London office?

He joined the Navy on the outbreak of the war and we were thrilled this morning to see in the papers that he had won the D. S. C. for sinking submarines in the Atlantic. He was always a good sportsman and was certain to do well at any job he went in for.

Every member of the L. R. B. & M. organization will get a thrill from knowing that one of our number has distinguished himself in this outstanding way and has won the top distinction of the D. S. C.

Lieutenant Douglas H. Campbell, of our Philadelphia staff, who is now serving with the Fifth Army in Italy, featured prominently in a dispatch from Hal Boyle, Associated Press Correspondent, which appeared in the *Philadelphia Evening Bulletin*. The major portion of this dispatch appears below:

LOCAL OFFICER HELPED RESCUE 1,000
WHEN STORM LEVELED HOSPITAL

The most dramatic example of wartime medical efficiency at the front came a few nights ago during the first heavy rainstorm of the season when furious gusts of wind within five minutes leveled every tent in a great field evacuation hospital.

The rain beat down in torrents soaking 1,000 sick or wounded soldiers, but in less than two hours they were all dry and warm again in a nearby tobacco warehouse, laughing and joking at the experience. Not a patient was lost or injured.

"In fact," said peppery little Lieutenant Colonel Phil A. Daly, of Chicago, "a couple of our seriously ill pneumonia patients, believe it or not, got better right away."

Colonel Daly, who superintended the removal, is director of the hospital staff. Even as the ward tents were blowing down he sent Lieutenant Douglas Campbell of Philadelphia to see if the hospital could move into the tobacco warehouse. Then he moved 200 of the patients most seriously ill to a big barn and hayloft across the field.

In the tobacco warehouse Private John MacClanahan of Sacramento, Calif., had just finished cleaning out some stables when

a dripping wet figure opened the door. That was Lieutenant Campbell. It was then about 10:30 P. M.

"There were only about 11 of us but we pitched in right away clearing out space for the patients and they began coming in soon in relays," said MacClanahan, who worked all night stringing lights after helping lay out the cots and linens. He also got out all his dry clothing from his barracks bag for the wet soldier patients and gave up his bed to a woman Red Cross worker.

Every group of soldiers for miles around was similarly helpful—signal, ordnance and quartermaster outfits—and lent their muscles and trucks in the hurried job of getting the patients from under the blown down tents and into their new sanctuary.

"It was really a mess, with mud over everything," said Colonel Daly. "How we got them all out of there in less than two hours I don't know. If we had planned this it would have taken days. The storm was almost a tornado. It blew over an X-ray generator."

"The only panic we had was among the few Italian civilian patients," recalled Chief Nurse Helen Wharton, of Iowa City, Iowa. "Signal boys across the way were the most helpful. They gave all their cigarettes to the patients, all their coffee, then wired them up some music."

"One operation was finished under the operating table by flashlight after the tent blew down," Captain Philip Marcus, of Chicago, said. "The patient is doing well."

After working all night getting settled, the nurses, doctors and ward workers had to spend all the next day drying and cleaning equipment.

The University of Pennsylvania, through its Wharton School of Finance and Commerce, arranged an all-day conference on War Contract Renegotiation and Termination, which was held at the University on November 23. Various

addresses were made, including a noteworthy one by Under Secretary of the Navy Forrestal. The latter half of the afternoon was devoted to four round-table sessions. At the round-table devoted to consideration of "Problems Arising in Preparation of Financial Statements of Companies Whose Contracts Are Subject to Renegotiation," Mr. Staub presented the subject in an opening talk and led the ensuing discussion.

On December 20 Mr. Staub addressed a joint meeting in Scranton of the local chapters of the National Association of Cost Accountants and the Pennsylvania Institute of Certified Public Accountants on the subject of Wartime Problems in the Presentation of Financial Statements.

Mr. Staub has been reappointed to the Committee on Taxation and Public Revenue of the Commerce and Industry Association of New York. He has served on this committee for a number of years, succeeding Colonel Montgomery, who had likewise served on the Committee for some years.

Mr. Dennis addressed the Fort Wayne Chapter of the National Association of Cost Accountants on December 21, his subject being "The Relationship Between the Public Accountant and the Internal Auditors." The NACA Bulletin of January 15 reported that "his subject was well presented and a

very interesting round table discussion followed."

Mr. Robert Buchanan, of our San Francisco staff, addressed the San Francisco Chapter of the NACA at its December meeting. He presented current tax matters affecting corporations and dealt particularly with claims under Section 722, amortization of war facilities, and proposed legislation in the near future.

The January 15 issue of the NACA Bulletin announced Mr. Herbert G. Bowles of our Los Angeles staff as one of a group that appeared on behalf of the Los Angeles Chapter on a radio program, "Quiz of Two Cities," which was put on in Los Angeles and participated in by the Los Angeles and San Francisco Chapters.

At the annual meeting of the Advisory Council of State Society Presidents, held during the annual meeting of the American Institute of Accountants in October last, Mr. Robert S. Warner read a paper on the new Missouri accountancy law. As Vice President of the Missouri Society of Certified Public Accountants, Mr. Warner was substituting for the President, who was unable to attend the Institute meeting.

Mr. Warner has been appointed by the Governor a member of the Missouri State Board of Account-

ancy under the above mentioned law recently enacted in that state for the regulation of the practice of public accounting.

Mr. Walter G. Draewell is serving as President of the San Francisco Chapter of the California Society of Certified Public Accountants.

War Contract Termination Settlements

(Continued from page 9)

tracts, either war work or commercial work. The Manual provides that the cost of common items may be charged to the contract "to the extent that the quantities of such items have been properly allocated between the work under the contract and other work." It appears evident that the War Department intends to accept a contractor's production planning schedules if it appears that they have been used consistently by the contractor. That is, if a certain quantity of common item material is earmarked according to the production timing schedules for the terminated contract, that quantity will be accepted as a charge in the settlement.

If a contractor does not have adequate records of the scheduling of materials and parts, with identification of the contracts or shop orders to which they relate, such records should be developed immediately. The same principle can be applied to the identification of purchase commitments. If there are no records in use for earmarking common items according to the contracts for which they are held, it is probable that the best settlement obtainable will be a proration according to the ratio of the material requirements of the cancelled contract to the total requirements of all contracts on which the common items could be used.

The Tentative Nature of Financial Statements Under Present Conditions

(Continued from page 24)

maintenance of general and branch office organizations, full amortization of emergency facilities, etc." United States Steel Corporation described its provision in a note to the statement of income in the following language:

For the year 1942, as in the year 1941, a reserve of \$25,000,000 was provided for those costs applicable to this period arising out of war and which because of the high rate of operations must be deferred until a future time, as well as for transition to a peace time basis at the end of the war.

SUMMARY OF SALES, FEDERAL TAXES AND WAR RESERVES OF 33 CORPORATIONS (000's omitted in stating amounts)

Report for Year Ended	Net Sales and Other Operating Income	Income before Federal Taxes and Reserves	Provisions for Federal Taxes ¹ Per Cent ²	Income after Federal Taxes but before "War" Reserves	Provisions for "War" Reserves Amounts Per Cent ³	Income after Federal Taxes and "War" Reserves Amounts Per Cent ⁴	Indicated Status of Renegotiation
Dec. 31, 1942	\$ 244,464	\$ 48,524	49.6	\$ 24,458	\$ 4,000	\$ 20,458	8.4
Dec. 31, 1942	216,317	25,942	38.3	13,367	5,500	12,567	5.9
Dec. 31, 1942	2,511,672	185,668	72.8	14,805	18,800	12,567	5.9
Dec. 31, 1942	67,832	17,685	72.8	4,805	5,800	4,005	5.9
Dec. 31, 1942	468,953	77,785	47.6	40,785	4,000	36,785	9.0
Dec. 31, 1942	36,787	6,796	65.3	2,356	500	1,856	5.0
Dec. 31, 1942	187,773	18,773	71.7	5,316	800	4,516	2.7
Sept. 30, 1942	393,769	61,317	74.5	15,650	3,186	12,464	3.2
Dec. 31, 1942	1,511,672	185,668	79.4	35,188	12,800	22,388	1.7
Dec. 31, 1942	1,421,619	223,314	68.6	7,002	None	7,002	4.9
Dec. 31, 1942	623,655	50,754	43.3	28,754	13,225	15,529	2.5
Nov. 30, 1942	304,014	57,449	74.2	14,814	4,000	10,814	3.6
Nov. 30, 1942	501,782	48,755	70.1	14,555	3,500	11,055	2.2
Dec. 31, 1942	17,834	4,146	72.7	1,131	2,200	931	5.4
Dec. 31, 1942	977,775	238,081	73.9	62,081	17,000	45,081	4.6
Dec. 31, 1942	2,201,897	281,009	44.3	124,501	23,986	132,522	6.0
Dec. 31, 1942	451,493	44,129	49.5	22,371	8,000	14,371	3.2
Dec. 31, 1942	114,378	27,160	74.1	7,047	1,500	5,547	4.8
Oct. 31, 1942	364,527	63,126	30.8	32,246	6,700	25,546	7.0
Dec. 31, 1942	108,021	23,659	66.1	8,030	2,460	5,570	5.2
Dec. 31, 1942	234,982	35,142	68.3	11,142	1,000	10,142	4.3
Dec. 31, 1942	259,444	93,892	45.9	50,821	2,000	48,821	18.8
Dec. 31, 1942	337,556	36,780	73.7	10,659	3,400	7,259	2.0
Dec. 31, 1942	22,271	20,235	72.6	5,535	3,150	2,385	10.7
Dec. 31, 1942	132,880	33,552	53.6	15,552	1,500	14,052	10.6
Dec. 31, 1942	196,019	28,892	60.0	9,817	815	9,002	4.6
Dec. 31, 1942	412,374	63,364	21.5	47,149	12,000	35,149	8.5
Dec. 31, 1942	516,371	62,458	44.6	20,394	13,897	7,097	1.4
Dec. 31, 1942	1,861,940	252,319	61.6	96,319	23,000	71,819	3.9
Dec. 31, 1942	487,275	71,916	69.0	22,314	4,947	17,367	3.6
	\$13,993,872	\$2,125,108	61.3	\$821,366	\$189,127	\$632,239	4.5

Notes:

- After deduction of post-war refund and debt retirement credits. In certain cases, where obviously appropriate, foreign income taxes are included.
- For cent of amount of income after federal taxes and war reserves.
- For cent of income after federal taxes but before "war" reserves.
- Per cent of net sales or gross operating income.
- Amounts of income on various bases shown for General Motors Corporation exclude \$31,129,500 of income of extraordinary character arising principally from reduction in 1941 federal income tax provisions.
- For comparative purposes, \$1,500,000 charged by the company to earned surplus (rather than to income) is included.
- For comparative purposes, \$10,000,000 charged by the company to earned surplus (rather than to income) is included.

For comparative purposes, \$10,000,000 charged by the company to earned surplus (rather than to income) is included.

Lybrand, Ross Bros. & Montgomery

Offices

<i>Cities</i>	<i>Addresses</i>
NEW YORK 4	Downtown, 90 Broad Street
17	Uptown, 1 East 44th Street
PHILADELPHIA 2	Packard Building
CHICAGO 4	231 South LaSalle Street
BOSTON 10	80 Federal Street
BALTIMORE 2	First National Bank Building
WASHINGTON 5	Investment Building
PITTSBURGH 22	Union Bank Building
DETROIT 26	Book Building
CLEVELAND 15	Midland Building
CINCINNATI 2	Carew Tower
LOUISVILLE 2	Heyburn Building
SAINT LOUIS 1	411 North Seventh Street
ROCKFORD	321 West State Street
ATLANTA 3	Healey Building
DALLAS 1	First National Bank Building
HOUSTON 2	Shell Building
SAN FRANCISCO 11	2 Pine Street
LOS ANGELES 13	510 South Spring Street
SEATTLE 1	Skinner Building

EUROPE

LONDON, ENGLAND . . . 3 St. James's Square, S. W. 1

